OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

March 17, 2008

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2007. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, Montgomery County Federal Credit Union, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were an estimated 5,100 active members and 5,160 retirees participating in the ERS as of December 31, 2007.

Performance Results

The total return achieved by the ERS assets for the quarter was a loss of 0.29%, 19 basis points ahead of the 0.48% loss recorded by the policy benchmark. For the one year period ending December 31, 2007 the estimated ERS' gross return (before fees) was 9.55%, 151 basis points ahead of the 8.04% return of the policy benchmark. The one-year return places the ERS' performance in the top 16% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 10.13%, before fees, ranking in the top 24% of the universe. The asset allocation at December 31, 2007 was: Domestic Equities 37.6%, International Equities 21.3%, Fixed Income 23.6%, Inflation Linked Bonds 10.3%, Private Equity 4.5%, Real Estate 2.3% and Cash 0.4%. We estimate that the funded status of the ERS was 81.9% as of December 31, 2007, an increase of 1% from a 80.9% funded status a quarter earlier. Note that the actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

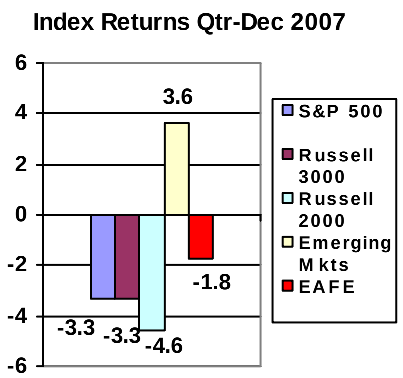
Major Initiatives

During the quarter, the Board continued to implement the revised asset allocation for the ERS by approving the selection of two long duration managers and allocations to two private equity partnerships. A gradual rebalancing of assets and implementation of new investment strategies and managers will continue to take place over the next several quarters. The Board also approved changes to their governance structure, created a Code of Professional and Ethical Conduct, and instituted a requirement that all vendor and manager contracts contain a provision requiring annual disclosure of any payment, gift, benefit, or contribution, or request for such item, that the manager or vendor provided during the previous calendar year.

Capital Markets and Economic Conditions

Following the sharp market shock in August, concerns about financial liquidity continued throughout the quarter due to stricter accounting rules and bank write-offs. In particular, investment banks have become very cautious, analyzing the contribution/detraction of lending activities to the bank's balance sheet and overall risk. Without market makers to help ease trading there was little confidence in the financial system during the fourth quarter. Global central banks were focused on deteriorating fundamentals in the U.S. housing sector and the Federal Reserve, Bank of England and Bank of Canada all cut rates in December. The dollar was weak against all major currencies through 2007, ending the year down over 15% versus the Canadian Dollar and nearly 11% versus the Euro.

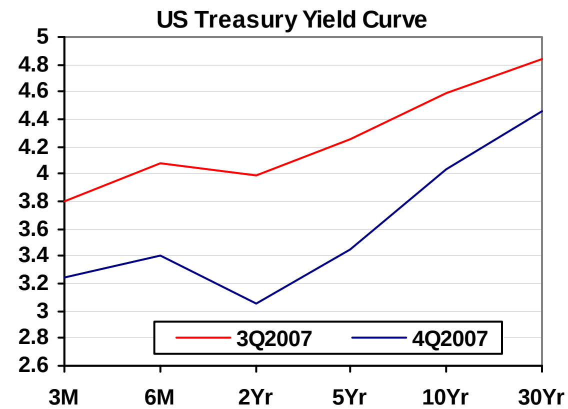
Despite the US concerns, there continues to be hope that global economic growth could be sustained, particularly in emerging markets. The International Monetary Fund notes that over half of the world's population now lives in urban areas reflecting a need for continuous improvement in education, employment, infrastructure, and standards of living. This is no more evident than in China where they continue to show 10-11% growth forecasts.



The U.S. equity markets ended the quarter in negative territory as deterioration in global credit markets and slowing of the domestic housing market continued to increase the risks of recession. As shown in the chart to the left, the large capitalization firms (as represented by the S&P 500 Index) outperformed smaller capitalization firms (as represented by the Russell 2000 Index). Growth stocks continued to outperform value stocks across the capitalization spectrum. The top performing sectors of the S&P 500 during the quarter were utilities, energy, and consumer staples, while financials and consumer discretionary were the worst performing sectors. Our combined domestic equity performance was a loss of 3.27%, 7 basis points ahead of the Russell 3000 benchmark index return. For the one year period ending December 31, our combined domestic equity performance was 6.43%, 129 basis points ahead of the benchmark's return of 5.14%.

Within the international markets, developed markets, as measured by the MSCI EAFE Index, were down 1.75% for the quarter compared to emerging markets which gained 3.63%. Among the EAFE markets Sweden (-12.75%) and Ireland (-11.21%) detracted the most from returns. The markets of Egypt (24.33%), Jordan (24.17%), and India (23.31%) posted the highest returns within the emerging markets sector. Our combined international equity performance was a gain of 0.15% (before currency managers' performance and .05% after) for the quarter, 81 basis points ahead of the benchmark loss of 0.66%. For the one year period ending December 31, our combined international equity returned 17.86% (18.46% after currency performance), outperforming the benchmark by 121 basis points.

The declining housing market and sub-prime losses have intensified the concerns about an approaching recession. Although this concern has seen a widening of credit spreads, there has been significant downward pressure on yields overall due to the demand for high quality instruments and the interest rate cuts by the Federal Reserve. At the end of December, the yield on 2-year Treasuries was down almost 1% for the quarter to 3.05% and 10-year Treasuries declined by over 0.5% to 4.02%. The ERS combined fixed income return for the quarter was a gain of 1.03%, trailing the 1.79% recorded by the benchmark index due to the significant widening of credit and mortgage securities. Investments in inflation-linked bonds recorded some of the strongest returns for the quarter, up 4.76%, 85 basis points ahead of the benchmark's return of 3.91%.



During the fourth quarter, our private equity managers called a combined $8.9 million of capital for our investments across their funds and paid distributions of $2.5 million. Our current allocation to private equity is 4.5%, with a market value of $125.0 million. There were capital calls from our real estate managers totaling $16.2 million and distributions of $3.9. Our current allocation to real estate is 2.3%, with a market value of $63.0 million.

Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending December 31, 2007 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 12/31/2007	Fiscal YTD
Employer Contributions	$ 29.8	$ 59.0
Member Contributions	5.1	9.6
Net Investment Income (Loss)	(16.9)	37.7
	$ 18.0	$ 106.3

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System
Deductions by Type (millions)

	Qtr 12/31/2007	Fiscal YTD
Benefits	$ 37.2	$ 73.2
Refunds	0.2	0.3
Administrative Expenses	0.5	1.0
	$ 37.9	$ 74.5

Outlook

2007 was an extraordinary period of volatility, all linked to one word – sub-prime. What started as a housing slowdown turned into more serious economic concerns and with markets continuing to deteriorate throughout the 4th quarter of 2007. Irrespective of the magnitude of the housing correction, it has become abundantly clear how intertwined global investment markets are. The financial sector in particular has come under heavy scrutiny during the second half of the year on two fronts – the amount of sub-prime mortgage backed securities on their balance sheets, as well as their part in the financial engineering to create the pools of mortgages, sold off in different layers of securitized debt. Lenders have temporarily battened down the hatches and credit is hard to come by.

We also see the impact in private equity markets, where leveraged buyouts in particular were also fueled by the easy availability of credit. Fear brings uncertainty and this leads to concerns about the credit worthiness of companies – high yield debt spreads have widened considerably over recent months. All of this on top of the fact we are late in the economic cycle and with the very real prospect of recession in the US, equity valuations have been tumbling over recent weeks.

Is the situation bad for all asset classes? Not for the asset classes that see increased demand from the classic flight to quality – in particular treasuries and inflation-protected securities. We believe the Board's investment approach to diversifying investment allocations across a number of different asset classes will provide the ERS with the best structure to weather future economic volatility. A diversified allocation should also help protect the ERS from any one particular economic outcome, particularly important when we see increased volatility in the marketplace.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
December 31, 2007

Assets		
Equity in pooled cash and investments	$	62,725
Investments:		
Northern Trust		2,728,525,588
Aetna		12,331,651
Fidelity - Elected Officals Plan		1,063,980
Total investments		2,741,921,219
Contributions receivable		8,354,743
Total assets		2,750,338,687
Liabilities		
Benefits payable and other liabilities		4,244,094
Net assets held in trust for pension benefits	**$**	**2,746,094,593**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
December 31, 2007

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 29,754,119	$ 58,921,097
Member	5,157,823	9,697,117
Total contributions	34,911,942	68,618,214
Investment income (loss)	(13,788,924)	43,754,464
Less investment expenses	3,136,213	6,056,800
Net investment income (loss)	(16,925,137)	37,697,664
Total additions	17,986,805	106,315,878
Deductions		
Retiree benefits	26,838,172	52,755,688
Disability benefits	8,668,956	17,049,497
Survivor benefits	1,681,983	3,345,209
Refunds	186,583	345,568
Administrative expenses	538,503	992,982
Total deductions	37,914,197	74,488,944
Net increase (decrease)	**(19,927,392)**	**31,826,934**
Net asset held in trust for pension benefits		
Beginning of period	**2,766,021,985**	**2,714,267,659**
End of period	**$ 2,746,094,593**	**$ 2,746,094,593**